



**A Report to the
Audit Committee**

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Bob Mendes
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Metropolitan
Nashville
Office of
Internal Audit

Audit of the Metropolitan Nashville Government's Debt Management Process

November 2, 2016



EXECUTIVE SUMMARY

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Why We Did This Audit

The purpose of this audit was to determine that bonds issued by Metro are properly issued, managed, and recorded in the financial statements. In addition, Experis compared nationally recognized Government Finance Officers Association Best Practices to the practices adopted by the Metropolitan Nashville Government.

What We Recommend

- Document and/or update existing Internal Control Environment.
- Update debt management policy to reflect language considered to be a Best Practice for derivatives.

AUDIT OF METROPOLITAN NASHVILLE GOVERNMENT'S DEBT MANAGEMENT PROCESS

BACKGROUND

Metropolitan Nashville Government's (the "Metro"), Department of Finance, is responsible for the debt management function through its Office of the Treasurer and Financial Operations divisions. Jointly these divisions are responsible for issuance, management, and financial reporting for the Metro's public financing of capital projects. Their primary responsibilities include:

- Entering into and initiating the issuance of public debt through municipal bond offerings.
- Management of service providers and minimization of costs associated with public offerings.
- Compliance with Local, State and Federal rules and regulations of the SEC.
- Recording of financial transactions related to the issuance and services of public offerings in the Metro's annual Comprehensive Annual Financial Report.

OBJECTIVES AND SCOPE

The objectives of this audit were to understand and evaluate the following areas impacting issuance and accounting of debt:

- Effectiveness of debt management practices, policies and procedures, including internal controls.
- Assessment of debt policy in accordance with the Government Finance Officers Association best practices on debt management.
- Compliance with regulatory agencies and Securities and Exchange Commission Rule 15c2-12.
- Analysis of credit rating and debt level through benchmarking against relative peers.
- Assessment of service agreements and fee structures with service providers as it pertains to Debt Management.

The audit scope included Debt Issuances beginning July 1, 2013, through June 30, 2015.

WHAT WE FOUND

During the audit, we identified the following areas of improvement:

- A. Internal Control documentation for the Department of Finance was either out of date or incomplete and not maintained in a centralized Internal Control Manual as required by the State.
- B. If Metro was to issue derivate debt instruments in the future, the current Debt policy does not address two provisions as recommended by the Government Finance Officers Association considered to be key to the management of these types of instruments.

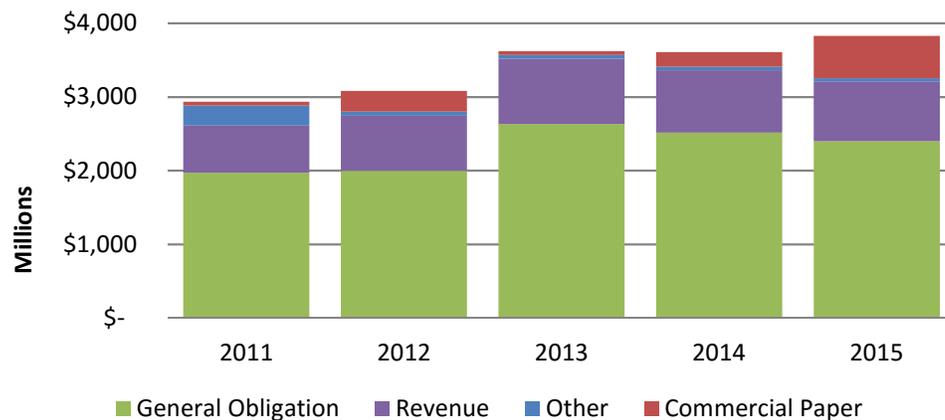
GOVERNANCE

The Metro Council causes bonds and other obligations of Metro to be issued subject to the restrictions delineated in Article 7, Bond Issues, of the Metropolitan Nashville Charter. The Metro Office of the Treasurer and Financial Operations divisions facilitates the process for issuance and accounting for bonds approved by the Metro Council.

FINANCIAL BACKGROUND

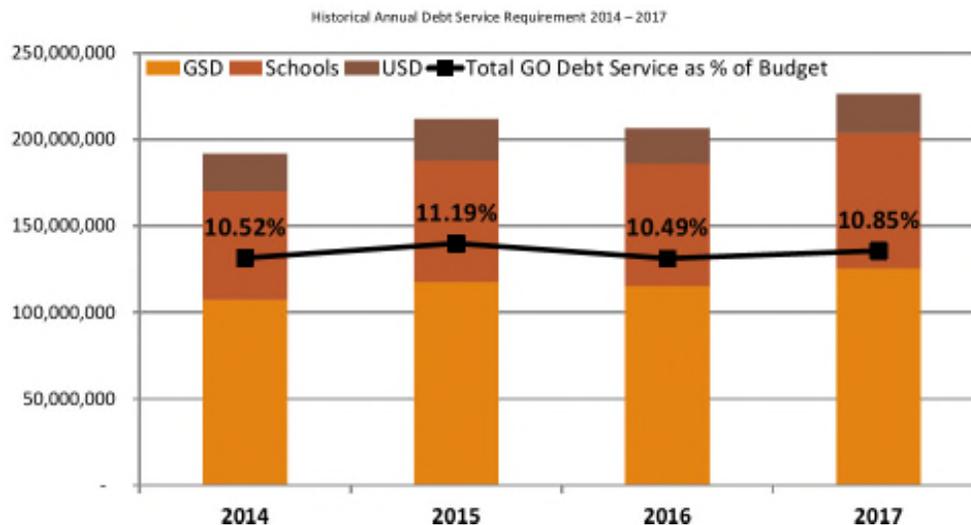
As shown in Exhibit 1, Metro’s total outstanding debt is \$3,828,821,464 as of June 30, 2015; this is a 30 percent increase since fiscal year end 2011. However, general obligation debt service has remained between 10.52 percent and 11.19 percent of Metro’s annual operating budget for fiscal years 2014 through 2017 (see Exhibit 2). Metro’s component units outstanding debt, consisting of primarily revenue bonds, is an additional \$1,576,844,144 as of June 30, 2015.

Exhibit 1 – Metro Total Outstanding Debt by Fiscal Year



Source: Metro’s Comprehensive Annual Financial Report

Exhibit 2 – Metro General Obligation Debt Service as Percent of Operating Budget



Source: Metro Finance Director’s FY2017 Budget Presentation, April 29, 2016

OBJECTIVES AND CONCLUSIONS

1. *Is there a level of awareness of the overall existing debt management practices, policies, and processes?*

Yes. Employees interviewed as part of the audit were aware and appear to be familiar with existing debt management policies, practices, and processes. Debt management policies, practices, and processes have been developed and are in place within the Office of the Treasurer and Financial Operations divisions. These collectively provide guidance to support Debt issued by the Metro is properly issued, managed and accounted for by these departments.

2. *Are debt management practices, policies, and procedures, including internal controls effective?*

Generally, yes. Updated and current Internal Control documentation was not available in a centralized repository for review; therefore, could not be tested for effectiveness. However, controls, as documented in policies, practices, and processes, reviewed during the audit for Metro's Treasury and Accounting divisions, appear to be effective. A Derivative Debt policy should be developed prior to the issuance of derivate debt instruments, as required by State law and in accordance with Government Finance Officers Association best practices. (See Observations A and B.)

3. *Are the debt management policies, practices, and processes reflective of the Government Finance Officers Association best practices of debt management?*

Yes. The majority of the Best Practices presented by the Government Finance Officers Association have been adopted by the Metro's Treasury and Accounting divisions. One area was noted where policies, practices, and processes could be improved to reflect Government Finance Officers Association recommendations:

- Update debt management policy to include language regarding upfront payments or premiums, and on selling options and the conditions under which derivative debt instruments can be utilized. (See Observations B.)

4. *Are bond issuances in compliance with regulatory agencies and Securities and Exchange Commission Rule 15c2-12?*

Yes. Bond issuances audited during the test period were found to be in compliance with the applicable regulatory agencies, including SEC Rule 15c2-12.

5. *Do metrics resulting from a credit rating and debt level analysis benchmark against a comparative group of peers appear appropriate?*

Yes. The benchmark review of the Metro's Credit Rating and Debt level found no evidence that either of these metrics were abnormal, suggesting no further investigation.

6. *Are service agreements and fee structure with the Metro's Client's Service providers in the best interest of Metro?*

Yes. Service agreements and fee structures for several service providers to the Office of the Treasurer and Financial Operations Divisions were reviewed, including underwriters, financial advisors, and counsel. Contracts and fee structures examined appeared reasonable and in the best interest of meeting the Metro's interests.

AUDIT OBSERVATIONS

Internal control helps entities achieve important objectives and sustain and improve performance. The Committee of Sponsoring Organizations of the Treadway Commission (*COSO*), *Internal Control – Integrated Framework*, enables organizations to effectively and efficiently develop systems of internal control that adapt to changing business and operating environment, mitigate risks to acceptable levels, and support sound decision making and governance of the organization. The audit observations listed are offered to assist management in fulfilling their internal control responsibilities.

Observation A – Internal Controls Documentation

Internal controls documentation for the Department of Finance is not maintained in a central Internal Control Manual to reflect current risks and the controls necessary to mitigate those risks.

It is Experis’s observation that defined and documented internal control environments have become a standard and not the exception for organizations: Private and Public companies, Governments and Not-For-Profit organizations. The development and implementation of a defined internal control environment has become the backbone for management in their pursuit to ensure accurate financial reporting and safeguarding assets. In addition to these goals, a defined internal control environment can:

- Improve and ensure consistency of processes within an organization.
- Prevent or detect fraudulent activity.
- Provide a documented framework that can be leveraged during periods of organizational change.
- Identify responsibilities for staff and management that can assist during staff transitions.
- Reduce the business risks that could adversely affect an organization’s reputation.

Criteria:

COSO, Selects and Develops Control Activities – Principle 10 –The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.

Recommendation for the management of the Finance Department to:

Define and document the Internal Control Environment for all divisions of the department. As a result, updates and changes to policies, practices, and processes should be made accordingly.

Observation B – Policy Improvement: Derivative Debt

Existing debt financing policy does not address two provisions related to derivative debt instruments as recommended by *Government Finance Officers Association, Use of Debt-Related Derivatives Related Products*.

These provisions are considered by the Government Finance Officers Association to be best practices and should be adopted by any issuer considering or using derivative debt instruments. It is understood that derivative financing instruments have not been issued by the Metropolitan Nashville Government in over nine years and not anticipated to be used in the foreseeable future.

Criteria:

- *COSO, Control Activities—Principle 12—Management establishes control activities that are built into business processes and employees’ day-to-day activities through policies establishing what is expected and relevant procedures specifying actions.*
- *Government Finance Officers Association Best Practice, Use of Debt-Related Derivatives Products -* These products (derivatives) should only be used when the issuer has developed a comprehensive derivatives policy that includes:
 - Prohibition or restrictions on taking upfront payments or premiums, and on selling options.
 - The conditions under which these types of products (Derivatives) can be utilized (i.e. bidding procedures, minimum benefit thresholds, valuation of no call or call options, policy on collateralization, and terms of master agreements).

Recommendation for the management of the Finance Department to:

Consider developing a debt financing policy for the use of derivative debt instruments as recommended by *Government Finance Officers Association Best Practice, Use of Debt-Related Derivatives Related Products.*

GOVERNMENT AUDITING STANDARDS COMPLIANCE

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our observations and conclusions based on our audit objectives.

METHODOLOGY

To accomplish our audit objectives, we performed the following steps:

- Interviewed key personnel within the Treasury and Accounting departments.
- Reviewed and analyzed documentation for compliance with the Tennessee Code Annotated, Metropolitan Nashville Code of Laws, and other applicable laws, regulations, and policies.
- Compared policies and practices with Government Finance Officers Association debt management recommended best practices.
- Reviewed sample selections to determine the effectiveness of processes and procedures.
- Considered risk of fraud, waste, and abuse.
- Considered information technology risks.

AUDIT TEAM

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October 31, 2016

Mr. Mark Swann
Metropolitan Auditor
Office of Internal Auditor
404 James Robertson Parkway
Nashville, TN 37219

Re: Audit of the Metropolitan Nashville Government's Debt Management Process

Dear Mr. Swann:

This letter acknowledges the Finance Department's receipt of the above referenced report. We have reviewed your observations and recommendations and have evaluated each for adoption in Metro's Debt Management Program. Actions will be taken as indicated in the Management Response.

We appreciate the methodology used in reviewing our debt management processes, particularly the cooperative effort in developing the final report, and considering our input and concerns during the entire process.

Regards,


Talia Lomax-O'dneal

APPENDIX A – MANAGEMENT RESPONSE AND CORRECTIVE ACTION PLAN

We believe that the Metro’s Treasury and Accounting management is in a unique position to best understand their operations and may be able to identify more innovative and effective approaches. We encourage them to do so when providing their response to our recommendations.

Recommendations	Concurrence and Corrective Action Plan	Proposed Completion Date
<i>Recommendation for the management of the Finance Department to:</i>		
<p>A. Define and document the Internal Control Environment for all divisions of the department. As a result, updates and changes to policies, practices, and processes should be made accordingly.</p>	<p>Accept. While Metro has strong internal controls throughout the Finance Department, as evidenced in management letters from the external auditors, Finance has already begun a project to better document those internal controls over the coming months in accordance with the State’s guidelines for an internal control manual. Several individuals have completed MTAS and CTAS training on developing the internal control manual, and will begin centralizing Metro’s internal control documentation into one comprehensive document.</p>	<p>June 2017</p>
<p>B. Consider developing a debt financing policy for the use of derivative debt instruments as recommended by <i>Government Finance Officers Association Best Practice, Use of Debt-Related Derivatives Related Products.</i></p>	<p>Accept. As required by T.C.A. § 9-21-130, Metro Council has adopted, by Resolution No. RS2011-94, and submitted to the State Comptroller the Debt Management Policy. This policy contains a section on synthetic debt but is not a derivative policy. Prior to entering into derivative debt, the State Guidelines for Interest Rate and Forward Purchase Agreements would require that Metro adopt a derivative policy. This policy would include among other items, the areas covered in this finding. Metro has no plans of entering into derivative debt but would develop a comprehensive derivate policy if that were to be considered in the future.</p>	<p>Prior to issuing derivative debt (not currently anticipated.)</p>